PayPal’s Private Governance | Edward Stringham

The nine most terrifying words in the English language are, "I'm from the government and I'm here to help."

Markets have a long history of generating rules and enforcement mechanisms from within (endogenously) rather than requiring market participants to wait for the State. Instead of attributing the success of markets to government bureaucrats and elected officials, we should instead thank PayPal founders like Peter Thiel, Max Levchin, and other providers of private governance who help make markets work.

PayPal was founded in 1999 to facilitate payments between any two parties with email addresses. No costly credit card accounts or merchant terminals were needed. What PayPal did not foresee was the degree of fraud to which it would be subjected. Fraudsters from all over the world would hack into accounts and transfer small amounts of money out of each one. By 2001 PayPal had gross revenues of $14 million per year, but was losing *$10 million per month* to fraudsters. At first the company went to the government to stop the fraud and recover the money. But in short order PayPal realized that relying on the government to solve its problems was hopeless.

PayPal gave the FBI evidence, but noticed that the government was not exactly up to date on the latest technology and would ask the company questions like, “What’s a banner ad?” according to one PayPal executive who spoke with me. The government had little ability to identify the anonymous fraudsters, and when PayPal identified them there was a “dispute between the FBI offices in San Jose and San Francisco over which of them had jurisdiction over Kazakhstan.” The government simply lacked the expertise to do anything to protect this new kind of market. And one can only wonder what perverse incentives led the FBI to quibble about jurisdictions before actually solving the case.

Yet, miraculously, chaos did not ensue. Rather than sitting around and hoping that government would solve its problems, PayPal took matters into its own hands. It developed a fraud monitoring system that used artificial intelligence to detect potentially fraudulent transactions. If 100 separate accounts were transferring $1,000 to one account and that recipient was suddenly attempting to withdraw $100,000, alarm bells would ring to have PayPal employees, not government, check up on the situation.

PayPal named its fraud monitoring system Igor, after one of the hackers defrauding it. It developed algorithms that could learn over time and became quite good at approving legitimate transactions and preventing bad ones. PayPal had to weigh the risk of letting bad transactions go through against the cost of turning down good ones. Rather than treating the problem of fraud as a legal problem, the company treated it as a risk management one.

The fact that PayPal could not go to government courts to have its contracts enforced *ex post* became irrelevant when PayPal successfully dealt with problems *ex ante*. In order to stay solvent, PayPal had to drop the Nirvana fallacy of government protection and devise its own security measures. PayPal basically assumed the risk of fraud on behalf of customers and profited immensely by reducing it. PayPal now processes $100 billion worth of transactions per year and has an industry-leading loss rate of only 0.5 percent. It prices the cost of fraud into each transaction, and that gives the company incentives to minimize it.

Payment processors associated with American Express, MasterCard, and Visa followed suit and now rely on scoring systems to estimate the probability that any transaction is fraudulent. You don’t have to worry

too much about being defrauded by an online merchant when you know that your credit card company takes steps to protect you.

Private solutions like these are quite common today, as they have been throughout history. Wherever we see government uninterested or incapable of protecting contracts, we see private parties taking steps to deal with the problems of fraud or the protection of property rights. I like to refer to these solutions as "private governance."

Government bureaucracy has fewer incentives to be responsive to the needs of market participants. Although we could assume that government will solve our problems, as Reagan's words imply—and as PayPal observed firsthand—such an assumption is often imprudent.

Rather than waiting for nonexistent government solutions, private parties can profit by coming up with private solutions. From reputation and dispute resolution mechanisms on eBay, to arbitration agreements that underpin most all markets, markets depend a lot less on government than most people think. Rather than viewing markets as a creation of government, or as something that must be constantly nurtured and protected—and kept under tight control—by government, we should recognize how robust markets really are.